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IN THE

Supreme Court of the United States

October Term 1971

No. 71-286

S.F.H., INC. (Formerly Sam Fortas Housefurnishing Company, Inc.), *Petitioner*

v.

~~UNITED STATES OF AMERICA~~ Commissioner of Internal Revenue, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

JAMES M. MARSH
JAMES J. CONVERY

Of Counsel:
LaBRUM AND DOAK
1500 Seven Penn Center Plaza
Philadelphia, Pennsylvania 19103

THE LEGAL INTELLIGENCER, 66 NORTH JUNIPER STREET, PHILA., PA. 19107

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~~UNITED STATES~~ OF AMERICA, *Respondent*

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The petitioner S.F.H., Inc. (Formerly Sam Fortas Housefurnishing Company, Inc.) respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit entered in these proceedings on May 28, 1971.

OPINIONS BELOW

The opinion of the majority of the Tax Court, the concurring opinion of Judge Drennen, and the dissenting opinion of Judge Fay joined by Judge Raum, are reported at 53 T.C. 28 (1969) and appear at page 23 of this petition.

The opinion of the Court of Appeals for the Third Circuit handed down on May 28, 1971, is not yet reported, but appears at page 15 of this petition.

JURISDICTION

The opinion and judgment of the Court of Appeals for the Third Circuit were handed down on May 28, 1971, and this petition for certiorari was filed within 90 days of that date.

This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

Whether, in the exercise of its supervisory power over the lower federal courts, this Court should review and reverse a decision of a court of appeals which has arbitrarily disallowed a taxpayer the net loss carryover deduction specifically allowed by Section 172 of the Internal Revenue Code of 1954, where

(a) there was no allegation of "trafficking" in operating loss carryovers, which the special limitations of Section 382(a) of the Code, on which the court of appeals relied, was enacted to prevent; and

(b) the legislative history of Section 382(a) clearly shows that the Congress did not intend to disallow the deduction where as here, the same business was continued after the change in ownership, and did not specify any required period of operation thereafter, whereas this court of appeals arbitrarily disallowed the deduction because the taxpayer was not operating the business on the last day of the taxable year; and

(c) the applicable regulations plainly do not contemplate disallowance of the net loss carryover where as, here, the earlier losses were produced by the same business operations which also produced the income sought to be offset?

STATUTORY PROVISIONS INVOLVED

Section 172 of the Internal Revenue Code of 1954, 26 U.S.C. §172, provides in pertinent part as follows:

"Sec. 172. Net Operating Loss Deduction.

"(a) Deduction allowed.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term 'net operating loss deduction' means the deduction allowed by this subsection."

Section 382(a) of the Internal Revenue Code of 1954 provides in pertinent part as follows:

"SEC. 382. SPECIAL LIMITATIONS ON NET OPERATING LOSS CARRYOVERS.

(a) Purchase of a corporation and change in its trade or business.—

(1) In general.—If, at the end of a taxable year of a corporation—

(A) any one or more of those persons described in paragraph (2) own a percentage of the total fair market value of the outstanding stock of such corporation which is at least 50 percentage points more than such person or persons owned at—

(i) the beginning of such taxable year, or

(ii) the beginning of the prior taxable year,

(B) the increase in percentage points at the end of such taxable year is attributable to—

(i) a purchase by such person or persons of such stock, the stock of another corporation owning stock in such corporation, or an interest in a

partnership or trust owning stock in such corporation, or,

(ii) a decrease in the amount of such stock outstanding or the amount of stock outstanding of another corporation owning stock in such corporation, except a decrease resulting from a redemption to pay death taxes to which section 303 applies, and,

(C) such corporation has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership of the fair market value of such stock,

the net operating loss carryovers, if any, from prior taxable years of such corporation to such taxable year and subsequent taxable years shall not be included in the net operating loss deduction for such taxable year and subsequent taxable years."

REGULATIONS INVOLVED

Regulation 1.382(a)-1(h)(5) provides in pertinent part as follows:

"These factors shall be evaluated in the light of the general objective of section 382(a) to disallow net operating loss carryovers where there is a purchase of the stock of a corporation and its loss carryovers are used to offset gains of a business unrelated to that which produced the losses."

Regulation 1.382(a)-1(h)(7) provides in pertinent part as follows:

"A corporation has not continued to carry on a trade or business substantially the same as that conducted before an increase in the ownership of its stock if the corporation discontinues more than a minor

portion of its business carried on before such increase. In determining whether the discontinued activities are more than 'minor' for purposes of the preceding sentence, consideration shall be given to whether the discontinuance of the activities has the effect of utilizing loss carryovers to offset gains of a business unrelated to that which produced the losses. This sub-paragraph may be illustrated by the following examples:

Example (1) X Corporation, a calendar-year taxpayer, is engaged in three separate businesses, A, B, and C. Approximately one-half of X Corporation's total business activities (measured in terms of capital invested, gross income, size of payroll, and similar factors) relates to business A, 30 percent to business B, and the remaining 20 percent to business C. On December 31, 1957, X Corporation has substantial net operating loss carryovers all of which are attributable to the operation of business C. On June 1, 1958, Y Corporation purchases at least 50 percent in value of X Corporation's outstanding stock and during 1959, X Corporation discontinues business C. As of December 31, 1959, X Corporation has not continued to carry on substantially the same trade or business as that conducted prior to the increase in ownership.

Example (2) Assume the same facts as in example (1), except that all of X Corporation's net operating loss carryovers are attributable to business A and that the capital released by the discontinuance of business C is used to revitalize business A. Since the discontinuance of business C does not result in the utilization of net operating losses attributable to one business to offset gains of a business unrelated to that which produced the losses, the discontinuance of such business does not of itself constitute the failure to carry on substantially the same trade or business as that conducted prior to the increase in ownership."

STATEMENT OF THE CASE

This case arose because the Commissioner of Internal Revenue, relying on Section 382(a) of the Internal Revenue Code of 1954, disallowed the net operating loss deduction to which petitioner was entitled under Section 172 of the Code for the taxable year ended June 30, 1962. As stated by the Tax Court, the case is one of first impression, involving the application of those two important sections of the Code.

The issue arose in the following manner:

For many years petitioner had engaged in the business of selling furniture at retail in Memphis, Tennessee. It filed its corporate income tax returns on the basis of taxable years ended June 30, and reported income from sales in accordance with the installment method of accounting. Petitioner filed its income tax return for the taxable year ended June 30, 1962, with the District Director of Internal Revenue, Philadelphia, Pennsylvania.

For the taxable year ended June 30, 1961, petitioner incurred a net operating loss of $167,807.18, which arose from the operation of the retail furniture business. After carrybacks, there remained $159,830.76 for carryover to future years.

As of July 1, 1961, the beginning of the taxable year in question, all of petitioner's outstanding capital stock was owned by Son-Mark Industries, Inc. On August 11, 1961, Son-Mark Industries, Inc., sold, in an arms-length sale, all of Petitioner's capital stock to Chester Tricot Mills, Inc., whose name was later changed to Merion Securities, Inc. (hereinafter referred to as Merion).

On October 27, 1961, Merion acquired control of Mount Clemens Metal Products Company, a Michigan corporation (hereinafter referred to as Mount Clemens).

On the same date petitioner sold all of its assets, subject to all of its liabilities, to Mount Clemens for cash, and

immediately purchased 85,000 shares of the Mount Clemens stock from Merion.

After October 27, 1961, the only assets owned by petitioner were 85,000 shares of Mount Clemens stock, cash of less than $1,000 and a claim for refund of federal income tax in the amount of $6,480.59.

On its income tax return for the taxable year ended June 30, 1962, petitioner reported gross profit from sales of $349,508.67. This consisted of $131,448.11, gross profit from current year's sales, and $218,060.56, gross profit from prior year's sales realized in the current year, by way of either current year's collections or the disposition by petitioner on October 27, 1961, of all its installment accounts receivable to Mount Clemens.

Petitioner also reported $230,183.27 in business expenses and deductions on its income tax return for the year at issue. As a result, all the income attributable to sales during the taxable year in question was absorbed by expenses incurred during the same period, so that the reported net income for the taxable year in question was attributable solely to the aforementioned payments on accounts receivable and installment obligations arising out of business of prior years.

On its income tax return for the year ended June 30, 1962, petitioner claimed a net operating loss deduction of $133,398.08, comprised entirely of a portion of the net operating loss carryover from the year ended June 30, 1961. The Commissioner disallowed this deduction, pursuant to section 382(a) of the Internal Revenue Code,[1] following which petitioner filed a timely petition for redetermination of the deficiency with the United States Tax Court. The facts were stipulated in the Tax Court.

A majority of the Tax Court, in an opinion by Judge Withey, denied petitioner the deduction on the ground that

1. The Commissioner did not make any claim that the deduction was questionable under Section 269 of the Internal Revenue Code relating to acquisitions made to evade or avoid income tax.

petitioner did not continue to operate the business after the change in ownership.[2] 53 T.C. 28 (1969).

Judge Fay, with the concurrence of Judge Raum, dissented on the ground that the majority had unduly extended the provisions of Section 382(a) beyond its intended scope, pointing out that the inapplicability of that section to this case is strongly supported by the regulations thereunder, and that the reactivation cases relied upon by the majority are conceptually and factually distinguishable from the instant case (53 T.C. 34).

Judge Drennen in a concurring opinion agreed that this is not the type of situation which the Congress had in mind when it enacted Section 382(a) to discourage trafficking in loss carryovers, but concluded that petitioner lost its right to the deduction because it was not carrying on the business at the *end* of the taxable year (53 T.C. 33).

The panel of the Court of Appeals, consisting of Circuit Judges Kalodner, Seitz and Aldisert, affirmed the decision of the Tax Court and disallowed the deduction because petitioner was not still conducting the business at the end of the tax year.

This petition challenges that ruling for the reasons set out in the dissenting and concurring opinions in the Tax Court, and in this petition.

REASONS FOR GRANTING THE WRIT

A panel of the Court of Appeals for the Third Circuit has denied petitioner the net loss carryover deduction granted by Section 172 of the Internal Revenue Code of 1954 by arbitrarily applying the "special limitations" of Section 382(a) of the Code in a situation not within the purview of the statute, the legislative history, or the regulations.

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2. In fact, the stock ownership changed on August 11, 1961, but the operating assets were not sold until October 27, 1961.

The proper relationship between Section 172, granting the deduction, and Section 382(a), applying "special limitations" in limited situations, has not been but should now be decided by this Court.

The egregious nature of the lower court's error, and the arbitrary manner of its application, may be briefly stated as follows:

(a) The statute—Section 382(a), in plain language, denies the operating loss carryover *only* where there has been a change of *both* the ownership and the business involved. As pointed out by the dissenting judges in the Tax Court, "Section 382(a) was enacted to curtail the traffic in net operating losses for the purpose of offsetting income of businesses *unrelated* to those which produced the losses. The congressional intention to limit the application of Section 382(a) to situations in which the income and losses arise from unrelated businesses is plainly revealed in the Committee reports" (emphasis in original).

In this case, there is admittedly *only one business involved*. Thus, it is a classic case for use of the deduction. "What history there is, suggests that Congress was concerned primarily with the fluctuating income of a *single business*." *Libson Shops v. Koehler*, 353 U. S. 382, 387 (1957) (emphasis added). The findings of fact by the Tax Court in this case make it clear that petitioner meets the standards urged on this Court by the government in the *Libson* case:

> "The government contends that the carryover privilege is not available unless there is a continuity of business enterprise. It argues that the prior year's loss can be offset against the current year's income only to the extent that this income is derived from the operation of substantially the same business which produced the loss. Only to that extent is the same 'taxpayer' involved." 385 U. S. 386.

Realizing that this case involved only a *single business*, and that the operating losses were derived from the

very same operations which produced the income, the court of appeals arbitrarily injected the additional disqualifying proviso that the taxpayer loses the deduction if it is not operating the business on the very day on which the tax year ended. The statute requires—naturally enough—that the *determination* of whether or not there has been a change in business (as opposed to continuity of the same business) be made "at the end of a taxable year." That is when the taxpayer's return will be submitted and the deduction claimed. But the statute does *not* say that the deduction can be disallowed unless the taxpayer continues to operate the business until the very end of the taxable year. In addition to representing judicial legislation circumventing the congressional intent, such a holding makes no sense.

First, it would deny the deduction to any business which had to cease operations because of losses in its final taxable year, which is in the exact situation the Congress contemplated in providing relief by permitting those losses to offset income earned by the same business. Indeed, under the decision below, a taxpayer could never have the benefit of an operating loss carryover in its last year of business unless it terminated the business on the last day of the taxable year. Thus the statute is effectively nullified.

Second, fixing that arbitrary date as the sole decisive factor would deny the deduction to a taxpayer whose losses forced it to cease operations even *one day* before the end of the taxable year, and nevertheless grant the deduction to another taxpayer who managed to keep going another day or two.

Blindly holding that the "continuing business" must be operating on the day when the taxable year ends is contrary to the plain language and clear meaning of Section 382(a). It also eviscerates Section 172 which was intended to inject some measure of equity into the corporate income tax situation as stated in *Libson Shops v. Koehler*, 353 U. S. 382, 386, 387.

In these times of rapidly fluctuating economic con-

ditions, and during the transition from a war economy to a peace economy, the proper application of these two sections of the Code is of critical importance, especially in the small business area. This Court should therefore resolve the issue which so divided the knowledgeable judges of the Tax Court and which, because of the erroneous decision of the Court of Appeals, may cause widespread hardship and injustice in that area of the economy.

(b) Another indication of the arbitrary nature of the decision below is the cryptic and misleading manner in which the court dismissed petitioner's showing that the legislative history supported petitioner's contention.

At the very end of its opinion, the Court of Appeals mentioned petitioner's contention and then quoted, as "dispositive of the contention" two sentences from the Conference Committee Report (reproduced as Appendix D to this petition). Those two sentences merely state that the Senate version of Section 382(a), adopted by the Conference, denies the deduction when the taxpayer does not carry on substantially the same trade or business after the change of ownership. There is nothing in the two quoted sentences of that report requiring that the business be in operation for any particular period of time after the change of ownership—only that the taxpayer carry on substantially the same trade or business after that date as it did before that date.

But the Conference Committee Report is, by its very nature, a less enlightening document than the original Senate Committee Report (reproduced as Appendix C to this petition) in which the Senate version of Section 382(a) is more fully explained. Each of the first three paragraphs of that document specifically points out that a corporation's eligibility for the Section 172 deduction is lost only if there was a "change in its trade or business." The third paragraph specifically states that elimination of the deduction pursuant to sub-paragraph (C) of paragraph (1) of Section 382(a) is effective *only* if the taxpayer "has not continued to carry on a trade or business substantially the same as

that conducted immediately before any change" in ownership.

The findings of the Tax Court establish that petitioner did none of the things which would trigger loss of the deduction in accordance with the Senate Committee Report. The only way the Court of Appeals could support denial of the deduction was to add the condition that the business must still be in operation to the very end of the taxable year.

The Congress did not either impose or intend to impose any such condition, and this Court should not permit such judicial legislation by the lower court.

(c) Finally, the lower court ignored the Internal Revenue Service's own regulations issued pursuant to Section 382(a), which indicate that the deduction is not to be disallowed under the circumstances of this case.

Regulation 1.382(a)-1(h)(5), after discussing the objective tests to be used to determine whether or not a change of business has occurred, emphasizes the overall objectives of Section 382(a). That regulation there states in pertinent part as follows: "These factors shall be evaluated in the light of the general objective of Section 382(a) to disallow net operating loss carryovers where there is a purchase of the stock of a corporation and its loss carryovers are used to offset gains of a business *unrelated to that which produced the losses*" (emphasis added).

Regulation 1.382(a)-1(h)(7) similarly emphasizes the vital significance of this factor.

As has already been noted, it is admitted that in this case there was *only one business* involved, and the losses were incurred in the exact same business operation as the income sought to be offset. No wonder the dissenting judges[3] in the Tax Court concluded that "the instant case

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3. As was also noted by the dissenting judges in the Tax Court, the "reactivation cases" such as *Barclay Jewelry, Inc. v. Commissioner*, 367 F.2d 193 (C.A. 1, 1966), and *Fawn Fashions, Inc.*, 41 T.C. 205, relied upon by the court of appeals, were in direct con-

is fundamentally outside the scope of Section 382(a) and that Section 382(a)(1)(C) must be construed in this perspective."

CONCLUSION.

Petitioner submits that the decision of the lower court in this case on an important question of federal law so far departs from accepted standards that review and correction by this Court is required. As has been shown, the lower court's decision flies in the face of the statute, the legislative history, and the applicable regulations. It also involves an important principle of corporate tax law which should be settled by this Court.

Respectfully submitted,

JAMES M. MARSH
JAMES J. CONVERY
1500 Seven Penn Center Plaza
Philadelphia, Pennsylvania

Of Counsel:
LaBRUM AND DOAK
1500 Seven Penn Center Plaza
Philadelphia, Pennsylvania

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trast with this case. Unlike those cases, this case involves a *single* business, the operation of which was *not* suspended when the change of ownership took place. Moreover, as pointed out by the same dissenting judges, under the circumstances of this case, there was no possibility of any windfall for petitioner, whose purchase of the business obviously took into account the existing net operating losses.

APPENDIX A

OPINION
OF THE
UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 18,730

S.F.H., INC. (Formerly Sam Fortas Housefurnishing Company, Inc.), *Appellant*

v.

COMMISSIONER OF INTERNAL REVENUE

ON APPEAL FROM THE UNITED STATES TAX COURT

Argued December 1, 1970

Before KALODNER, SEITZ and ALDISERT, *Circuit Judges*

OPINION OF THE COURT
(Filed May 28, 1971)

KALODNER, *Circuit Judge*.

The question presented is whether the Tax Court erred in holding that the appellant corporation was precluded by Section 382 of the Internal Revenue Code of 1954,[1] which prescribes "Special limitations on net operating loss carryovers," from carrying over to its taxable year ended June 30, 1962, a net operating loss sustained in a prior taxable year, because it had sold all of the assets of its retail furniture business and ended the latter's opera-

1. 26 U.S.C.A. §382.

tion some eight months prior to the end of the taxable year.

Relevant to our disposition are these stipulated facts found by the Tax Court:

The taxpayer, S.F.H., Inc. (formerly Sam Fortas Housefurnishing Company, Inc.), had for many years engaged in the business of selling furniture at retail in Memphis, Tennessee. It filed its corporate income tax returns on the basis of a taxable year ended June 30, and reported income from sales in accordance with the installment method of accounting. Taxpayer filed its federal corporate income tax return for the taxable year ended June 30, 1962, with the District Director of Internal Revenue, Philadelphia, Pennsylvania.

For the taxable years ended June 30, 1961, taxpayer incurred a net operating loss of $167,807.18, which arose from the operation of the retail furniture business. After carrybacks, there remained $159,830.76 for carryover to future years.

As of July 1, 1961, all of taxpayer's outstanding capital stock was owned by Son-Mark Industries, Inc. On August 11, 1961, Son-Mark Industries, Inc. sold, in an arm's length transaction, all of taxpayer's capital stock to Chester Tricot Mills, Inc., whose name was later changed to Merion Securities, Inc. ("Merion").

On October 27, 1961, Merion acquired control of Mount Clemens Metal Products Company ("Mount Clemens"), a Michigan corporation. On the same date, taxpayer sold all of its assets, subject to all its liabilities, to Mount Clemens for cash, and then immediately purchased 85,000 shares of the stock of Mount Clemens from Merion.

After October 27, 1961, and on June 30, 1962, the last day of the taxable year in issue, taxpayer had no assets with which to carry on the retail furniture business. After October 27, 1961, taxpayer's only assets were 85,000 shares of Mount Clemens stock, cash of less than $1,000, and a claim for refund of federal income tax in the amount of $6,480.59. Taxpayer did not engage in any other busi-

ness from October 21, 1961 until its dissolution in its fiscal year ending June 30, 1964. It had no gross income during its fiscal years ending June 30, 1963 and June 30, 1964.

On its income tax return for the year ended June 30, 1962, taxpayer reported gross profit from sales of $349,508.67. This consisted of $131,448.11, gross profit from current year's sales, and $218,060.56, gross profit from prior years' sales realized in the current year, by way of either current year's collections, or the disposition by taxpayer on October 27, 1961, of all of its installment accounts receivable to Mount Clemens. On its income tax return for the year ended June 30, 1962, taxpayer claimed a net operating loss deduction of $133,398.08 comprised entirely of a net operating loss carryover from the year ended June 30, 1961.

In his notice of deficiency, the Commissioner disallowed this net operating loss deduction with the following explanation:

> "Within your taxable year ended June 30, 1962, all your capital stock was purchased by new owners, Chester Tricot Mill, Inc., and by the end of said taxable year ended June 30, 1962, you had ceased to carry on the retail furniture business heretofore conducted by you. Accordingly, under the provisions of section 382(a) of the Internal Revenue Code of 1954, the net operating loss carryover from prior taxable years had been disallowed as a deduction in the year ended June 30, 1962."

The Commissioner's determination was sustained by the Tax Court in a reviewed decision, two judges dissenting, at 53 T.C. 28 (1969).

The sum of the taxpayer's challenge to the Tax Court's decision may be summarized as follows: (1) Congress in enacting Section 382 sought only to deal with "trafficking" in corporations with operating loss carryovers, viz., acqui-

sition of a corporation for the purpose of utilizing its loss carryover to offset gains of the acquiring corporation's unrelated business; (2) "the legislative history of section 382(a) clearly shows that the Congress intended it to apply only where a change in ownership was accompanied by a change in business and an attempt was made to offset a loss carryover against profits from a different business than that which sustained the loss"; and (3) the Tax Court erred in premising its denial of the carryover loss "on the fact that it [the taxpayer] terminated its business."

The Commissioner urges that the Tax Court correctly decided that under Section 382 the taxpayer was not entitled to a loss carryover from a prior taxable year to the taxable year ended June 30, 1962, and that the legislative history of Section 382 is in accord.

What has been said brings us to resolution of the taxpayer's challenge to the Tax Court's decision.

On review of the record, we are of the opinion that the Tax Court did not err when it held that, under the prevailing undisputed facts, Section 382 disallows the taxpayer's claimed carryover loss and that the Section's legislative history supports, rather than negatives, the Tax Court's holding.

Section 382(a)(1), set forth in the margin,[2] prohibits

[2] § 382. Special limitations on net operating loss carryovers

(a) Purchase of a corporation and change in its trade or business

(1) In general. If, at the end of a taxable year of a corporation

(A) any one or more of those persons described in paragraph

(2) own a percentage of the total fair market value of the outstanding stock of such corporation which is at least 50 percentage points more than such person or persons owned at

(i) the beginning of such taxable year, or

(ii) the beginning of the prior taxable year,

(B) the increase in percentage points at the end of such taxable year is attributable to

a corporation from carrying over to a current taxable year an otherwise allowable prior year's net operating loss "*[i]f, at the end of a taxable year,*" there has been a sale of 50% or more of the corporation's stock during the taxable year, and "*such corporation has not continued to carry on a trade or business substantially the same as that conducted before any change*" in the stock ownership. (emphasis supplied)

The Tax Court held that since the taxpayer had admittedly "abandoned" all operation of its retail furniture business prior to the end of the taxable year June 30, 1962; Section 382 disallowed its claimed loss carryover into that year. In doing so, it ruled that "[a]t a minimum . . . the statute requires that the corporation *continue* the old business" as of the end of a taxable year, where, during that year, there has been a 50% or more change of a corporation's capital stock. 53 T.C. 33. (the emphasis is that of the Tax Court).

In further exposition of its holding, the Tax Court said (p. 33):

> "The net operating loss deduction, as other income tax deductions, reflects an act of legislative grace. *New*

(i) a purchase by such person or persons of such stock, the stock of another corporation owning stock in such corporation, or an interest in a partnership or trust owning stock in such corporation, or

(ii) a decrease in the amount of such stock outstanding or the amount of stock outstanding of another corporation owning stock in such corporation, except a decrease resulting from a redemption to pay death taxes to which section 303 applies, and

(C) such corporation has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership of the fair market value of such stock.

the net operating loss carryovers, if any, from prior taxable years of such corporation to such taxable year and subsequent taxable years shall not be included in the net operating loss deduction for such taxable year and subsequent taxable years.

> *Colonial Co. v. Helvering*, 292 U.S. 435 (1934); *Deputy v. duPont*, 308 U.S. 488 (1940). The availability of any particular deduction may be conditioned by Congress upon compliance with statutory requirements which it sees fit to enact thereon. Section 382(a) provides a limitation upon the use of a corporation's net operating loss carryovers in the computation of its net operating loss deduction where there is a substantial change in the stock ownership of that corporation. Congress, in effect, stated in section 382(a) that a corporation which experiences a substantial change in its stock ownership may enjoy the benefit of its net operating loss carryovers *only if* it continues to carry on substantially the same trade or business as that conducted before the change in ownership. Petitioner has failed to comply with this statutory directive."

In response to the taxpayer's contention, here renewed, that Section 382 does not apply where the loss carryovers are sought to be used to offset gains of the same business and there has been no "change in business," the Tax Court said (p. 32):

> "The fact that petitioner has not *changed* its old business, but has instead *abandoned* it does not alter the result under section 382(a); i.e., disallowance of the loss carryover."

We agree in every respect with these stated determinations of the Tax Court.

In the instant case, it is undisputed that the taxpayer conclusively terminated all operation of its retail furniture business when it sold all of the latter's operating assets, including accounts receivable, for cash, on October 27, 1971 —eight months prior to the end of its taxable year June 30, 1962. Indeed, taxpayer concedes that after October 27, 1961 it did not carry on *any* trade or business whatsoever. That being so, since there had been a change of more than

50% of the taxpayer's capital stock during the taxable year ended June 30, 1962,[3] it was, on the latter date, required by Section 832(a)(1)(C) "to carry on a trade or business substantially the same as that conducted before" the stated change in its ownership, in order to qualify for use of its prior year's loss carryover.

The taxpayer's failure to satisfy this requirement is fatal to its loss carryover claim.

It is pertinent to note that other Courts have subscribed to the Tax Court's ruling that Section 832 requires a corporation which has experienced a change in ownership, "to carry on substantially the same trade or business," at the end of the taxable year, in order to enjoy use of its prior year's loss carryover.

In Commissioner of Internal Revenue v. Barclay Jewelry, Inc., 367 F.2d 193 (1 Cir. 1966), it was held that a corporation which, following sale of its capital stock, did no business for two years thereafter, and then resumed its former operation, did not meet the requirements of Section 382(a)(1)(C) of continuous carrying on of business, and consequently was not entitled to use its loss carryover.

In so holding, the Court, speaking through Chief Judge Aldrich said (p. 196):

> "We do not think it was either unreasonable, or an inadvertence, that the statute requires *both* that the nature of the *business not be changed* and that the *operations continue* despite the change in ownership." (emphasis supplied).

In discussing the provisions of Section 382(a)(1)(C), it was said in Glover Packing Company of Texas v. United States, 328 F.2d 342 (Ct. Cl. 1964) at page 348:

> "This seems to convey the idea of *continuous operation* without a substantial break." (emphasis supplied).

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3. The taxpayer sold all of its outstanding capital stock to Merion on August 11, 1961—some six weeks after the beginning of its taxable year ended June 30, 1962.

There remains for disposition the taxpayer's contention that the legislative history of Section 382 establishes that "this section is inapplicable here."

The following excerpt from the Conference Report is dispositive of this contention:

> "In the case of a 50 percent or more change of ownership by reason of a purchase or redemption of stock, the Senate amendment *completely eliminated the net operating loss carryovers provided the corporation did not continue to carry on a trade or business substantially the same as that conducted before the change of ownership.* If a corporation continued to carry on substantially the same trade or business, the limitation [of §382(a)(1)(C)] would not be applicable even though the corporation also added a new trade or business."[4] (emphasis supplied).

For the reasons stated the decision of the Tax Court entered pursuant to its Opinion will be affirmed.

4. Conference Report, H.R. Rep. No. 2543, 83d Cong. 2d Sess. (1954), U.S. Code Cong. & Admin. News 1954 at page 5299.

APPENDIX B

OPINION OF TAX COURT OF THE UNITED STATES

53 T. C. No. 5

S.F.H., INC (Formerly Sam Fortas Housefurnishing Company, Inc.), Petitioner *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 2352-67 Filed October 8, 1969.

Arthur S. O'Neill, Jr., for the petitioner.

Albert Squire, for the respondent.

S.F.H., Inc., petitioner, for a number of years was engaged in the retail furniture business. On August 11, 1961, all of petitioner's stock was sold to Merion Securities, Inc. On October 27, 1961, Merion Securities, Inc., acquired control of Mount Clemens Metal Products Company, and on the same date had petitioner sell all its assets, including its installment basis accounts receivable, to Mount Clemens. Thereafter, until its liquidation two years later, petitioner engaged in no trade or business. On its income tax return for the year ended June 30, 1962, petitioner claimed a net operating loss deduction comprised entirely of a net operating loss carryover from the year ended June 30, 1961. *Held*, section 382(a) is applicable to disallow petitioner's use of its net operating loss carryover from the previous taxable year.

WITHEY, *Judge:* Respondent determined a deficiency in petitioner's income tax for the taxable year ended June 30, 1962, in the amount of $109,182.23.

After concessions by the parties on several issues, there remains for decision only the question of whether respondent properly disallowed petitioner's net operating loss carryover from the prior taxable year pursuant to section 382(a)[1] in computing petitioner's net operating loss deduction for 1962.

1. All statutory references herein are to the Internal Revenue Code of 1954 unless otherwise indicated.

FINDINGS OF FACT

All of the facts having been stipulated, they are so found.

S.F.H., Inc., (formerly Sam Fortas Housefurnishing Company, Inc.), hereinafter referred to as petitioner, filed its Federal corporate income tax return for the taxable year ended June 30, 1962, with the district director of internal revenue, Philadelphia, Pennsylvania.

Petitioner had for many years engaged in the business of selling furniture at retail in Memphis, Tennessee. It filed its corporate tax returns on the basis of a taxable year ended June 30, and reported income from sales in accordance with the installment method of accounting.

For the taxable year ended June 30, 1961, petitioner incurred a net operating loss of $167,807.18, which arose from the operation of the retail furniture business. After carrybacks, there remained $159,830.76 for carryover to future years.

As of July 1, 1961, all of petitioner's outstanding capital stock was owned by Son-Mark Industries, Inc. On August 11, 1961, Son-Mark Industries, Inc., sold, in an arm's length sale, all of petitioner's capital stock to Chester Tricot Mills, Inc., whose name was later changed to Merion Securities, Inc. (hereinafter referred to as Merion).

On October 27, 1961, Merion acquired control of Mount Clemens Metal Products Company, a Michigan corporation (hereinafter referred to as Mount Clemens). On the same date, petitioner sold all of its assets, subject to all its liabilities, to Mount Clemens for cash, and then immediately purchased 85,000 shares of the stock of Mount Clemens from Merion.

After October 27, 1961, and on June 30, 1962, petitioner had no assets with which to carry on the retail furniture business, the only assets owned by the petitioner being 85,000 shares of Mount Clemens stock, cash of less than $1,000 and a claim for refund of Federal income tax in the amount of $6,480.59.

For the year ended June 30, 1963, and until its liquidation for the year ended June 30, 1964, petitioner had no gross income and only the following deductions:

	Year ended	
	June 30, 1963	June 30, 1964
Professional fees	$100.00	$75.00
Insurance	—	20.70
Miscellaneous	41.60	—
Total deductions	$141.60	$95.70

On its income tax return for the year ended June 30, 1962, petitioner reported gross profit from sales of $349,508.67. This consisted of $131,448.11, gross profit from current year's sales, and $218,060.56, gross profit from prior years' sales realized in the current year, by way of either current year's collections, or the disposition by petitioner on October 27, 1961, all of its installment accounts receivable to Mount Clemens.

On its income tax return for the year ended June 30, 1962, petitioner claimed a net operating loss deduction of $133,398.08, comprised entirely of a net operating loss carryover from the year ended June 30, 1961.

In his notice of deficiency, respondent disallowed this net operating loss deduction with the following explanation:

> Within your taxable year ended June 30, 1962, all your capital stock was purchased by new owners, Chester Tricot Mills, Inc., and by the end of said taxable year ended June 30, 1962, you had ceased to carry on the retail furniture business heretofore conducted by you. Accordingly, under the provisions of section 382(a) of the Internal Revenue Code of 1954, the net operating loss carryover from prior taxable years had been disallowed as a deduction in the year ended June 30, 1962.

OPINION

The issue presented in this case is whether section 382(a)[2] applies to disallow petitioner's net operating loss carryover under the following circumstances: Petitioner had been actively engaged in the retail furniture business for a period of years. On August 11, 1961, the stock of petitioner was sold in an arm's length sale to Merion. Thereafter, on October 27, 1961, Merion acquired control of Mount Clemens, and had petitioner sell all its assets to

2. SEC. 382. SPECIAL LIMITATIONS ON NET OPERATING LOSS CARRYOVERS.

(a) Purchase of a Corporation and Change in Its Trade or Business.—

(1) In General.—If, at the end of a taxable year of a corporation—

(A) any one or more of those persons described in paragraph (2) own a percentage of the total fair market value of the outstanding stock of such corporation which is at least 50 percentage points more than such person or persons owned at—

(i) the beginning of such taxable year, or

(ii) the beginning of the prior taxable year,

(B) the increase in percentage points at the end of such taxable year is attributable to—

(i) a purchase by such person or persons of such stock, the stock of another corporation owning stock in such corporation, or an interest in a partnership or trust owning stock in such corporation, or

(ii) a decrease in the amount of such stock outstanding or the amount of stock outstanding of another corporation owning stock in such corporation, except a decrease resulting from a redemption to pay death taxes to which section 303 applies, and

(C) such corporation has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership of the fair market value of such stock,

the net operating loss carryovers, if any, from prior taxable years of such corporation to such taxable year and subsequent taxable years shall not be included in the net operating loss deduction for such taxable year and subsequent taxable years.

Mount Clemens for cash, which cash petitioner used to immediately purchase 85,000 shares of Mount Clemens stock from Merion. Petitioner then ceased to actively operate the retail furniture business, and conducted no other trade or business until its dissolution two years later. However, for its taxable year ending June 30, 1962, petitioner reported approximately $350,000 in gross income arising from its operation of the retail furniture business for part of the taxable year, and from the deferred income portion of installment accounts receivable which arose from furniture sales made in prior years, which accounts were either collected during the taxable year or transferred to Mount Clemens.[3] Petitioner's current expenses for 1962, while greater than its profits from current sales, were less than its total reported gross profit because of the recognition of the deferred income portion of the installment accounts receivable, and it is this excess income against which petitioner seeks to offset its net operating loss carryover.

On the basis of these facts, respondent contends that all the requirements of section 382(a) are satisfied.[4] Petitioner, while not disputing the existence of the requisite percentage change in stock ownership, or that a "purchase" of petitioner's stock was made by the "persons" described in section 382(a)(2), challenges respondent's conclusion that it has not continued to carry on a trade or business substantially the same as that conducted before the change in ownership, as required in section 382(a)(1)(C).

Petitioner, while recognizing that the statute if taken on its face disallows the loss carryovers herein, argues that the legislative history of section 382(a)(1)(C) indicates that Congress did not intend that section to apply under the circumstances presented in this case. We disagree.

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3. Section 453(d)(1) provides for the recognition of taxable income upon the sale of an installment obligation.

4. Respondent makes no alternative contention that section 269 is applicable to disallow the net operating loss carryovers, and we do not consider the question.

Petitioner points to S. Rept. No. 1622, to accompany H.R. 8300 (Pub. L. 591), 83d Cong., 2d Sess. (1954),[5] as establishing two main points: first, that the abuse Congress sought to correct by the enactment of 382(a) was the situation where a loss carryover is used to offset gains from a business unrelated to that which produced the loss; and second, that it was intended that section 382(a)(1)(C) apply only where a corporation "engages in a different type of business" after a change in its stock ownership. Thus, petitioner argues, where the loss carryovers are used to offset gains of the same business, and where after the change in ownership a different type of business was not conducted,[6] section 382(a)(1)(C) should not apply.

5. Under present law where a controlling interest in a corporation is acquired for the purpose of avoiding or evading tax liabilities the Internal Revenue Service may disallow the benefits of a deduction, credit, or disallowance which would otherwise be enjoyed by the acquiring person or corporation. This provision has proved ineffectual, however, because of the necessity of proving that tax avoidance was the primary purpose of the transaction. It has also been so uncertain in its effects as to place a premium on litigation and a damper on valid business transactions.

The House Bill added a provision designed to limit undue tax benefits of this character by restricting the amount of net operating loss carryover which may be deducted where 50 percent or more of the participating interest in a corporation was acquired by new owners. Your committee adopted this provision with modifications noted below.

* * * *

Your committee has adopted a provision *to limit the application of this provision* relating to purchase *to* those areas in which abuse has most often arisen, that is, *the purchase of the stock* of a corporation with a history of losses for the purpose of using its loss carryovers *to offset gains of a business unrelated to that which produced the losses*. Accordingly, your committee has provided that if more than 50 percent of the stock of a corporation is purchased within a 2-year period *and if the corporation thereafter engages in a* different type of business, then the loss carryover *is eliminated*. [Emphasis added.]

6. Petitioner asserts that after the sale of its assets it did not carry on *any* trade or business. Cf. Rev. Rul. 67-186, 1967-1 C.B. 81.

We think petitioner reads the intent of Congress in regard to section 382(a) too narrowly. We agree with petitioner that a primary concern of Congress was whether there was a *change* in the nature of the taxpayer's business. In addition, however, we think that in order to escape the grasp of section 382(a)(1)(C) it is implicit in that subsection not only that the nature of the business remain unchanged, but also that some form of business operations continue subsequent to change in ownership. *Commissioner v. Barclay Jewelry, Inc.*, 367 F.2d 193, 196 (C.A. 1, 1966), reversing a Memorandum Opinion of this Court. The fact that petitioner has not *changed* its old business, but has instead *abandoned* it does not alter the result under section 382(a), i.e., disallowance of the loss carryover.

The rationale behind a continuity of enterprise requirement is not reflected in the legislative history of section 382(a). However, the Court of Appeals for the First Circuit in the *Barclay* case, *supra*, gave a cogent explanation for such a requirement. In that case, S & S purchased the stock of Barclay Company, a manufacturer of jewelry, and Barclay Jewelry, Inc., the taxpayer, a wholesaler of jewelry and principal customer of Barclay Company. After the stock purchases, S & S sold the Barclay Company products through their own agency, and the taxpayer, although remaining in existence, neither did nor attempted any business. After approximately two years, taxpayer was reactivated to sell jewelry as before, and produced a profit to which it sought to apply the operating loss shown on its books before its purchase by S & S. Discussing the continuity requirement, the Court stated:

> We read the statute as providing that only those persons who purchased *with the intention of carrying on the business* and using the loss deduction, and who, therefore, presumably, in agreeing on a purchase price, compensated the persons who suffered the loss, can obtain the deduction. Rather than place upon the Commissioner the burden of proving the purchaser's

> subjective intent at the time of the purchase, Congress required the purchaser to demonstrate his intent by *actually continuing the business*. . . . [Emphasis added.]

At a minimum, it is thus clear that the statute requires that the corporation *continue* the old business.[7]

The net operating loss deduction, as other income tax deductions, reflects an act of legislative grace. *New Colonial Co. v. Helvering*, 292 U.S. 435 (1934); *Deputy v. du Pont*, 308 U.S. 488 (1940). The availability of any particular deduction may be conditioned by Congress upon compliance with statutory requirements which it sees fit to enact thereon. Section 382(a) provides a limitation upon the use of a corporation's net operating loss carryovers in the computation of its net operating loss deduction where there is a substantial change in the stock ownership of that corporation. Congress, in effect, stated in section 382(a) that a corporation which experiences a substantial change in its stock ownership may enjoy the benefit of its net operating loss carryovers *only if* it continues to carry on substantially the same trade or business as that conducted before the change in ownership. Petitioner has failed to comply with this statutory directive.

Although the precise issue before us is one of first impression, the courts have considered the situation where an active business becomes inactive prior to a change in control thereof, followed by the reactivation of the same line of business (*Glover Packing Company of Texas v. United States*, 328 F.2d 342 (Ct. Cl., 1964); *Fawn Fashions, Inc.*, 41 T.C. 205 (1963); sec. 1.382(a)-1(h)(6), Income Tax Regs.), as well as the situation where an active business

7. The question of what constitutes such a continuation, as distinguished from the inauguration of a new enterprise, see; for example, *Glover Packing Company of Texas v. United States*, 328 F.2d 342 (Ct. Cl. 1964), does not concern us in this case as petitioner concedes that after the change in ownership it carried on *no* trade or business.

experiences a change in control followed by a period of inactivity, and then reactivates the old line of business (*Barclay Jewelry, Inc., supra*), concluding in both instances that the continued carrying on of a substantially similar business for purposes of section 382(a)(1)(C) had not occurred. We see no reason why the conduct of an active business prior to a change in control, followed by *permanent inactivity*, is any less a failure to continue to carry on a substantially similar business within the intendment of section 382(a)(1)(C).

We therefore hold that section 382(a) is applicable herein to disallow petitioner's net operating loss carryovers.

Reviewed by the Court.

Decision will be entered under Rule 50.

Concurring Opinion

DRENNEN, J., concurring: I agree with Judge Fay that this is not the type of situation which Congress had in mind when it enacted section 382(a) to discourage trafficking in loss carryovers; however, I must agree with the majority that the statute as written requires the disallowance of the loss carryover, where there has been the requisite change of ownership, unless the corporation continues to carry on a trade or business substantially the same as the business which produced the loss *at the end of the taxable year of the corporation.* Were it not for the fact that the taxpayer here sold all of its receivables as well as its other business assets prior to the end of its taxable year, I would be inclined to hold that the collection of those receivables as of the end of the taxable years would have furnished sufficient business continuity to meet the requirements of the statute, and the objectives of Congress. However, such was not the case so I must agree with the majority. Furthermore, taxpayer appears to have conceded that it did not carry on any trade or business subsequent to the sale of its assets.

Dissenting Opinion

FAY, J., dissenting: In my view, the majority unduly extend the provisions of section 382(a) beyond its intended scope. I think their strict interpretation of section 382(a)(1)(C) ignores the underlying purpose of that provision.

Section 382(a) was enacted to curtail the traffic in net operating losses for the purpose of offsetting income of businesses *unrelated* to those which produced the losses. The Congressional intention to limit the application of section 382(a) to situations in which the income and losses arise from unrelated businesses is plainly revealed in the Committee Reports.[1]

In the case at bar, however, the income in question was undeniably derived from the *same* business that produced the operating losses for which petitioner seeks a net operating loss carryover. Petitioner's gross income during the taxable year at issue was primarily attributable to the collection in that year of accounts receivable which had been created during prior years, and to installments received and reported during the taxable year in question pursuant to section 453. The balance of its gross income was derived from sales made during its taxable year ended June 30, 1962. All the income attributable to such sales was absorbed by expenses incurred during the same period so that the reported net income for the taxable year in question was attributable solely to the aforementioned payments on accounts receivable and installment obligations. Under such circumstances, I would not disallow a net operating loss carryover to petitioner. I think that the condition contained in section 382(a)(1)(C) has not been met in the instant case and that section 382(a) is therefore inapplicable.

Section 382(a)(1)(C) provides that a net operating loss

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1. S. Rept. No. 1622, 83d Cong., 2d Sess., (1954). See footnote 5 in the majority opinion which sets forth the text of this report.

carryover shall be disallowed only if "such corporation has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership." Where the new owners do not initiate a new business and instead the corporation continues to derive all of its income solely from the business conducted in prior years, I would readily conclude that the corporation continued to carry on the same trade or business within the intendment of section 382(a)(1)(C).[2]

The majority suggest that their holding is required by this Court's prior holding in *Fawn Fashions, Inc.*, 41 T.C. 205 (1963), and by *Barclay Jewelry, Inc. v. Commissioner*, 367 F.2d 193 (C.A. 1, 1966), involving the reactivation of a dormant business following a change in ownership of a corporation. These cases have disallowed the claimed net operating loss carryover, under section 382(a). See also section 1.382(a)-1(b)(6), Income Tax Regs.

While I agree with the reactivation cases, I think that they are both conceptually and factually distinguishable from the case at bar, and any reliance upon them is misplaced. Therefore, I feel that a fresh consideration of the applicability of section 382(a) to the facts herein presented is in order.

In the case of a business which is dormant at the time a change in ownership takes place but which is subsequently revived by the new owners, the denial of a net operating loss carryover is clearly warranted because, as the Court pointed out in *Barclay*, the taxpayer seeks to gain the benefit of operating losses incurred in a prior business by offsetting such losses against income generated by a "different business." The reactivated business, albeit similar in type to the defunct business, can nevertheless be appropriately termed unrelated to such business because

2. I do not regard petitioner's statement on brief that the prior business activities were discontinued as a concession by him that this statutory requirement was not met. I think petitioner's statement alluded to the facts rather than the legal conclusions to be drawn therefrom.

of the lack of continuity between them. A change in business may be in the temporal rather than qualitative dimension. *Barclay Jewelry, Inc. v. Commissioner, supra* at 196. By applying section 382(a) to reactivation situations, the effort has been to prevent the trafficking in net operating losses *within the same industry* which, clearly, is within the framework of, and intent of section 382. *Clarksdale Rubber Co.*, 45 T.C. 234, 245 (1965). Significantly, however, the instant case involves a *single* business operation since no reactivation took place. This salient feature, in my mind, sharply distinguishes the reactivation cases from the case at bar. Unlikely *Barclay* and *Fawn Fashions*, the income which petitioner seeks to offset by the operating losses of prior years was generated by the *same* and not an unrelated or different business. I think that section 382(a) cannot apply to a case in which the income sought to be offset consists solely of income realized in prior years, the recognition of which was deferred to the taxable year in question.

A second rationale suggested in *Barclay* for restricting the allowance of a net operating loss carryover to cases in which the business continues to operate after the change in ownership is that the purchaser, who is to derive the benefit of the net operating loss carryover, "presumably, in agreeing on a purchase price, compensated the persons who suffered the loss." In the instant case, since the collection of accounts receivable and installment payments was, in all probability, anticipated at the time of the change in ownership, petitioner likewise compensated the seller for the net operating loss carryover and therefore should not be denied a net operating loss on this basis either.

The inapplicability of section 382(a) to the instant case is also strongly supported by the regulations thereunder. Section 1.382(a)-1(h)(7) provides:

> (7) A corporation has not continued to carry on a trade or business substantially the same as that conducted before an increase in the ownership of its stock if the corporation discontinues more than a minor

> portion of its business carried on before such increase. *In determining whether the discontinued activities are more than "minor" for purposes of the preceding sentence, consideration shall be given to whether the discontinuance of the activities has the effect of utilizing loss carryovers to offset gains of a business unrelated to that which produced the losses.* . . . [Emphasis added]

Thus, under the regulations, the corporation is treated as not having continued to carry on a trade or business only if the discontinuance of a portion of such business has the effect of utilizing loss carryovers to offset gains of a business unrelated to that which produced the losses. No meaningful distinction can be drawn between a partial discontinuance and a complete discontinuance of business activities in this respect. Since the income, in this case, was generated by the same business as the losses in question, it follows that section 382 is inapplicable. The mechanical approach to section 382(a)(1)(C) adopted by the majority is thus clearly rejected by the regulations.

I think that the denial of a net operating loss carryover in the final year of a business, in which no portion of the reported income is attributable to an unrelated business but rather to business operations of prior years, under section 382(a), goes beyond the intent of Congress in its enactment of section 382(a). Recognizing that the construction placed upon section 382(a) by the majority may be consistent with a narrow reading of the statutory language, I think it entirely unfaithful to the spirit of that section as expressed in the Committee Reports. I think that the instant case is fundamentally outside the scope of section 382(a) and that section 382(a)(1)(C) must be construed in this perspective.

RAUM, J., agrees with this dissent.

APPENDIX C

SENATE COMMITTEE REPORT
(83d Cong., 2d Sess., S. Rep. No. 1622 (1954) 284)

§382. Special limitations on net operating loss carryovers: Your committee has retained this section of the House bill but has made some changes and additions. The section in the House Bill provided generally that if 50 percent or more of a corporation's stock changed hands during a 2-year period as the result of a purchase or redemption of stock, the net operating loss carryovers of such corporation would be reduced by the percentage of the change of ownership. The section now provides, generally, that if 50 percent or more of a corporation's stock changes ownership during a 2-year period as the result of a purchase or redemption of stock, and if the corporation changes its trade or business, then any net operating loss carryovers will be entirely eliminated. In addition, the section contains a new limitation on net operating loss carryovers in those corporate reorganizations described in section 381. This provision reduces the net operating loss carryovers of either the transferor or acquiring corporation unless there is a 20 percent or more continuity of interest in the resulting corporation retained by the stockholders of the corporation with the net operating loss carryovers.

If a limitation in this section applies to a net operating loss carryover, section 269, relating to acquisitions made to evade or avoid income tax, shall not also be applied to such net operating loss carryover. However, the fact that a limitation under this section does not apply shall have no effect upon whether section 269 applies.

Subsection (a) applies to the purchase of a corporation and change in its trade or business. It is applicable to any corporation which falls within each of the three conditions specified in subparagraphs (A), (B), and (C) of paragraph (1). Subparagraph (A) provides that 1 or more of the 10

largest unrelated stockholders must own, at the end of the taxable year, a percentage of the fair market value of the outstanding stock which is at least 50 percentage points more than such person or persons owned at either the beginning of such taxable year or the prior taxable year. Thus, subsection (a) will not be applicable unless the 10 largest stockholders own at least 50 percent of the fair market value of the outstanding stock and, then, will only be applicable if 1 or more of such 10 persons has increased the percentage of the fair market value of the outstanding stock he or they own by 50 percentage points or more during the specified period. An increase of 50 percentage points does not mean the same as a 50-percent increase. Thus, a stockholder who owns 4 percent of the fair market value of the outstanding stock and who increases his ownership to 6 percent has had a 50-percent increase in ownership but only a 2 percentage point increase. Paragraph (3) of subsection (a) gives the rules for determining ownership of stock and paragraph (2) specifies the persons to be used in determining whether the conditions in subparagraph (A) have been met. Subparagraph (B) provides that the increase of 50 percentage points required in subparagraph (A) must be caused by a purchase by the person who has the increase or by a decrease in the amount of outstanding stock (but not a decrease resulting from redemption to pay death taxes to which sec. 303 applies). The subparagraph is worded so as to prevent avoidance of the limitation through the purchase of an interest in a corporation, partnership, or trust owning stock in the corporation with the net operating loss carryover. An increase in percentage of stock owned resulting from a purchase by some other person, a tax-free reorganization, a gift, or a devise is not counted in determining whether the 50 percentage point increase has been reached. Subparagraph (C) contains the third condition which must be met before the limitation in subsection (a) is applicable. It provides that if the corporation has not continued to carry on a trade or

business substantially the same as that conducted immediately before any change in the percentage ownership of the fair market value of the stock, the condition in subparagraph (C) is met. The change in percentage ownership refers to an increase which would be counted under subparagraphs (A) and (B) in determining whether the 50 percentage point increase has been reached. If, as a result of such an increase, the corporation shifts from one type of business to another, discontinues any except a minor portion of its business, changes its location, or otherwise fails to carry on substantially the same trade or business as was conducted before such an increase, then the condition in subparagraph (C) is met.

Paragraph (2) of subsection (a) specifies the 10 persons (more or less) who are used to determine whether there has been a 50 percentage point increase in the ownership of the fair market value of the outstanding stock. The attribution rules specified in paragraph (3) are applicable in determining the ownership of stock. It is provided, however, that persons so related to each other that the stock of one is attributed to the other shall be considered as only 1 person solely for the purpose of selecting the 10 persons (more or less) who own the greatest percentage of the fair market value of the stock. For example, assume A, the largest stockholder of X corporation, owns 60 percent of the fair market value of the outstanding stock and has 9 living children. Under the attribution rules, each of the 9 children will be considered to own 60 percent also. However, in selecting the 10 persons described in paragraph (2), A and his children will be considered only 1 person and it will be necessary to select at least 9 more persons owning the next largest percentage of stock or such lesser number as there are persons owning the remaining stock. Even though, for purposes of paragraph (2), related persons are considered as only one person, in applying the conditions in paragraph (1), each person is to be considered separately.

Paragraph (3) specifies the attribution of ownership

rules which are to be applied in determining the ownership of stock for purposes of subsection (a).

Subsection (b) is designed to prevent the liberalized carryover of net operating losses permitted in section 381 from being used by one corporation to acquire the total net operating loss carryovers of another corporation without giving up at least a 20 percent share to the stockholders of the corporation with the net operating loss carryover. If the stockholders of the loss corporation have a 20 percent or more interest in the successor corporation, it is felt there is a sufficient continuity of interest in the net operating loss carryover to justify permitting the entire net operating loss to carry over. If, however, the stockholders of the loss corporation receive less than a 20 percent interest in the successor corporation, the net operating loss carryover is reduced as provided in paragraph (2). The 20 percent continuity of interest requirement is intended to apply to the corporation which includes the net operating loss carryover in its net operating loss deduction. Thus, the 20 percent requirement cannot be watered down by inserting the corporation with the loss and the corporation deducting the loss.

Paragraph (1) sets out the general rule which is applicable only in the case of a reorganization specified in paragraph (2) of section 381(a). In such a case, it is applicable regardless of whether the transferor corporation, the acquiring corporation, or both, have a net operating loss carryover. The stockholders of the corporation with the net operating loss carryover must own, as a result of owning stock in the loss corporation immediately before the reorganization, 20 percent or more of the fair market value of the outstanding stock of the acquiring corporation or the reduction in paragraph (2) will apply. For example, assume X corporation has a net operating loss carryover to 1955 of $100,000 and assets valued at approximately 4 percent of the value of the assets of Y corporation. Y merges into X in a statutory merger on December 31, 1954. Y's stockholders own, as a result of the reorganization, 96 per-

cent of the fair market value of X's outstanding stock and X's stockholders now own 4 percent of such fair market value. In such a case, the limitation would be applicable to the net operating loss carryover to 1955 because the stockholders of the loss corporation owned only a 4 percent interest in the successor corporation. Assume the above example and the additional fact that on December 30, 1954, X's stockholders purchased one-third of Y's stock from its stockholders. After the reorganization, X's stockholders before the reorganization would own 4 percent of X's stock as a result of owning stock of the loss corporation and 32 percent (one-third of 96 percent) of X's stock as a result of owning stock in X corporation. Hence, the limitation would also apply.

The reduction of the net operating loss carryover is determined in paragraph (2). In the above examples, the stockholders of the loss corporation owned 4 percent of the fair market value of the outstanding stock of the acquiring corporation as the result of owning stock of the loss corporation. Under paragraph (2), the 4 percent would be multiplied by 5 to give 20 percent and this amount would be subtracted from 100 percent to give the percentage of reduction, 80 percent.

Paragraph (3) provides that the limitation in subsection (b) shall not apply if the transferor corporation and the acquiring corporation are owned substantially by the same persons in the same proportions.

Paragraph (4) provides for the appropriate reduction in a net operating loss carryover not completely absorbed in the year in which the limitation in this subsection is applicable. The effect of this paragraph is to apply the reduction against the oldest net operating loss first, and then, if necessary, against subsequent net operating losses in order.

Subsection (c) gives the definition of stock. It is applicable to both subsections (a) and (b).

APPENDIX D

CONFERENCE COMMITTEE REPORT
(83d Cong., 2d Sess., H. Rep. No. 2543 (1954) 39)

Section 382 of the House bill contained a special limitation reducing the carryover of a corporate net operating loss if, during two consecutive taxable years, there was a 50 percent or more change in the ownership of the participating stock of the corporation by reason of a purchase or redemption of the stock.

The Senate amendment modified the limitation in the House bill and added a new limitation which was applicable in certain nontaxable reorganizations. In the case of a 50 percent or more change of ownership by reason of a purchase or redemption of stock, the Senate amendment completely eliminated the net operating loss carryovers provided the corporation did not continue to carry on a trade or business substantially the same as that conducted before the change of ownership. If the corporation continued to carry on substantially the same trade or business, the limitation would not be applicable even though the corporation also added a new trade or business. In the case of certain nontaxable reorganizations, the Senate amendment provided for a reduction in the net operating loss carryovers if the stockholders of the loss corporation owned, as a result of owning stock in the loss corporation, less than 20 percent of the stock of the acquiring corporation. The Senate amendment also made some changes to conform section 382 to other changes which it made in the House provisions. These changes included the elimination of the term "participating" from the definition of stock. The definition of stock in the Senate amendment excluded ordinary preferred stock but is intended to include stock having substantially the attributes of common stock even though nonvoting.

The effect of the action recommended in the accompanying conference report would be to accept the text of section 382, as contained in the Senate amendment, with two changes. The first adds to section 382(a), a paragraph (4), definition of purchase, which is similar to the definition in section 382 of the House bill. The second change adds paragraphs (5) and (6) to section 382(b). Under paragraph (5), if one of the corporate stockholders of the loss corporation is also a party to a reorganization specified in section 382(b)(1), even though such stockholder disappears in the reorganization or becomes the acquiring corporation in the reorganization (and hence, in either case, would not own stock in the acquiring corporation immediately after the reorganization), such stockholder will be considered to own a percentage of the stock of the acquiring corporation. Such percentage will be determined by the following ratio:

> X (the percentage of stock of the acquiring corporation considered to be owned by such stockholder immediately after the reorganization) is to the percentage of stock of the loss corporation owned immediately before the reorganization as the value of the total outstanding stock of the loss corporation immediately before the reorganization is to the value of the total outstanding stock of the acquiring corporation immediately after the reorganization.

Paragraph (6) added to section 382(b) permits stockholders of the loss corporation who own, as a result of the reorganization, stock of a corporation controlling the acquiring corporation to treat such stock as if it were an equivalent amount (measured by value) of stock of the acquiring corporation for the purpose of applying the limitation in section 382(b). This is not intended to permit a corporation desiring the benefits of a net operating loss carryover from another corporation to water down the 20 percent requirement by first combining a subsidiary which can meet the 20 percent test with the loss corporation and

then completely liquidating the enlarged subsidiary. The requirement that the shareholders of a loss corporation have a 20 percent continuity of interest is intended to apply to an interest in the corporation desiring to use the net operating loss carryover.